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Supreme Court Overturns Rule Forbidding Vertical Price Fixing

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The antitrust laws no longer automatically forbid agreements between a manufacturer (or supplier or franchisor) and its resellers that fix the minimum price at which goods are resold. Since 1911, the rule has been that an agreement between a manufacturer and a retailer that the retailer would not resell the manufacturer's good below a specified minimum price was *per se* (automatically) illegal. But on the final day of its October 2006 term, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, the Supreme Court held that an agreement between a manufacturer and a reseller on the final selling price of the manufacturer's goods is illegal only if its anticompetitive effects outweighed its procompetitive benefits.

<u>Summary</u>

- *Leegin* permits a resale price maintenance agreement only if, on balance, the agreement is procompetitive.
- *Leegin* is not a free pass for vertical pricing agreements.
- The law in some states may continue to forbid resale price maintenance agreements, so care must be taken to comply with state as well as federal law.
- *Leegin* gives greater flexibility to franchisors and brand companies thinking of supplementing or replacing company-owned retail networks with franchises.
- Franchisors must take care that, given the characteristics of the relevant markets, the pricing agreements are on balance procompetitive, and must be particularly sensitive to state laws that still might follow the old rule.
- Franchisors should maintain procedural safeguards to prevent illegal horizontal activity.

<u>Analysis</u>

The Sherman Act prohibits contracts, combinations and conspiracies that unreasonably restrain trade. Some types of restraints of trade are considered always or nearly always to result in increased prices or decreased output or both. These are considered *per se* illegal, and therefore are quickly condemned by courts without any inquiry into market power or market structure or competitive effect. Horizontal agreements among competitors to fix price or output, or allocate markets or customers, for example, are *per se* illegal. Other restraints are examined under the "rule of reason": they are condemned only after an examination of the relevant market, and only if their anticompetitive effects are shown to outweigh their procompetitive benefits. The Supreme Court adopted the rule of reason early in its antitrust jurisprudence to evaluate restraints of trade that could have procompetitive benefits even while also having some anticompetitive effects.

One of the Supreme Court's earliest decisions under the Sherman Act, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, considered a vertical agreement between a manufacturer of medicines and its distributors that required the distributors to resell the medicines at specified prices. The Supreme Court concluded that agreements having the destruction of competition and the fixing of prices as their sole purpose "are not saved by the advantages which the participants expect to derive from the enhanced price to the consumer." The rule in *Dr. Miles* condemned vertical agreements on price as *per se* illegal.

Legal and economic analysis during the ensuing 96 years led courts to conclude that the competitive effects of vertical arrangements, such as agreements among a supplier and its resellers, are often difficult to evaluate unless closely analyzed. A manufacturer might wish to promote its new brand or products, for example, by requiring its retailers to make investments in sales demonstrations and product support that could only pay off if all of the retailers of the same brand made the same investments and charged prices high enough to recoup the costs of those investments. Otherwise, discount retailers could free-ride on the investments of full-price retailers. Thus, the Supreme Court eventually excluded from the *per se* rule in *Dr. Miles* vertical restraints not directly related to price, such as territorial restrictions, and vertical agreements that set maximum, but not minimum prices.

In *Leegin*, the Court revisited the question presented in *Dr. Miles*. It concluded that although vertical agreements setting minimum resale prices can be unreasonable, they can also be reasonable, especially when they stimulate interbrand competition (by reducing intrabrand competition). A resale price maintenance agreement could allow investments in showrooms and sales staff that permit product demonstrations or suggest that the product is of high quality, or enable retailers to provide services that consumers prefer to receive, or facilitate the introduction of new firms and products. The Court concluded, therefore, that proper evaluation of the legality of a vertical restraint was not the automatic condemnation of the *per se* rule, but rather at least some examination of the restraint's procompetitive benefits and anticompetitive effects.

Abandoning the bright-line rule of *per se* illegality in favor of the fact-intensive rule of reason creates challenges for manufacturers and distributors. Under the old rule, the only way to impose a resale price maintenance scheme was by the manufacturer's unilateral announcement that it would terminate retailers who failed to adhere to suggested resale prices; communication from resellers that they would adhere to the deal or that alleged other retailers were undercutting the suggested prices could render the scheme illegal. A unilateral agreement that was legal under the Sherman Act before *Leegin* remains legal now. But now, in certain circumstances, resellers can explicitly agree to abide by resale price maintenance arrangements. Resale price maintenance agreements are likely to survive antitrust scrutiny, for example, where the products have only a modest share of the relevant market, where investments are made to support the sale or service of the product, or where consumer choice is somehow enhanced. On the other hand, such arrangements may be illegal, for example, where the product has a large market share, where the arrangement is a cover for cartel behavior by manufacturers or retailers, or where retailers jointly encourage the manufacturer to adopt a scheme whose only purpose is to increase the price that all the retailers must charge. The new rule is not a free pass: vertical price setting agreements are not automatically legal.

Leegin will likely have immediate practical effects on vertical arrangements in markets whose structure is likely to lead to the conclusion that a resale price maintenance arrangement is probably reasonable. Manufacturers with unilateral resale price maintenance agreements in place in such markets probably no longer need to be careful to ensure that all communications regarding resale price policies are unilateral. They can probably ask their resellers to agree to abide by the resale price policies, and they can probably reinstate terminated discounters who agree to follow pricing policies in the future.

<u>State Law</u>

Most states have their own versions of the Sherman Act, and most of these statutes are interpreted consistently with the Sherman Act either because a state high court has decided to do so or because a provision of the statute requires it. Nonetheless, a state might not follow *Leegin* if there is a statute or legal precedent specifically prohibiting resale price maintenance. Maryland, for example, specifically forbids resale price maintenance arrangements concerning gasoline products. Louisiana, for example, will not follow a federal antitrust precedent that conflicts with state case law.

It is difficult to predict whether the states will follow *Leegin*. The attorneys general of a number of states have been active in opposing further limits to the application of the *per se* rule, as they opposed overruling *Dr. Miles*. The Vertical Restraints Guidelines of the National Association of Attorneys General (revised in 1995) make clear that state attorneys general consider resale price maintenance agreements to be *per se* illegal under both state and federal law. Some state attorneys general may continue to treat such vertical agreements on price as illegal *per se* as a matter of policy. Moreover, because *Dr. Miles* has been the law for so long, there are bound to be many state court decisions following its *per se* rule. We might even see a number of state legislatures enact statutes repealing *Leegin* as we saw several decades ago when approximately 20 states refused to go along with the Supreme Court's rule in *Illinois Brick Co. v. Illinois*, which prohibited actions under the federal antitrust laws by indirect purchasers seeking damages arising from an agreement among the defendants to fix prices.

<u>Implications for Franchising</u>

Leegin is likely to have a significant impact on newly drafted franchise agreements. With all franchisors implementing changes to their disclosure documents mandated by the January 2007 revision to the Federal Trade Commission Franchise Rule and related state regulatory interplay, the long-standing approach of avoiding price issues might be reconsidered at the same time. Some brand companies, especially those with relatively low market shares, may be able to exercise price control through franchise agreements, allowing them to shed vertical retail networks or supplement them with franchises. Franchisors must take care, however: *Leegin* says that vertical price restraints will be evaluated under the rule of reason; it does not say that all or even most vertical price restraints are automatically legal. It expressly acknowledges that minimum resale prices can encourage new entrants, particularly higher service retailers who are now subjected to the brutal discipline of discounting. Franchisors of goods that require that retailers provide a high level of service to be successful in the market may take comfort in *Leegin* because it is now more likely that a retail price maintenance agreement will survive antitrust scrutiny.

The Court offered no guidance on whether goods manufactured by the retailer from materials, ingredients or inputs provided or prescribed by the brand company, or services created and delivered by the retailer according to standards prescribed by the brand company, could be the subject of resale price maintenance. The same economic justifications for the rule of reason approach, promotion of interbrand competition and discouraging free riding by no-service discounters, may well apply to locally manufactured goods and services, but that is a case yet to be decided. What is clear is that those who employ minimum resale price maintenance arrangements must be prepared to provide evidence of procompetitive effects on interbrand competition. If such effects are doubtful, or the anticompetitive effects of the price maintenance arrangement are significant, a franchisor should avoid the arrangement. The availability of competitors and substitute products increases the likelihood that the arrangement will not be found to be anticompetitive.

Franchisors, particularly product distribution franchisors, should be wary of implementing a minimum retail price maintenance program for a number of reasons. First, franchise agreements often contain express reservations of pricing authority for franchisees. These defensive measures protected both parties during the era, now ended, when vertical price restraints were *per se* illegal.

Second, the franchisor should not have market power in the price-restrained item, but the Court does not specify what concentration of sales strength in the market is the threshold. Is it the 30% market share established in the Supreme Court's *Jefferson Parish* decision for higher scrutiny in tying cases, or some different level? We won't know until courts actually evaluate vertical price restraints under the rule of reason. We would not be surprised to see a split among the Circuit Courts on this important issue.

Third, the direction of the restriction is critical. An effort by competing retailers to establish minimum prices may be regarded as a horizontal conspiracy and may therefore be condemned as *per se* illegal. Horizontal agreements among competitors on price and output remain *per se* violations of the Sherman Act, so the procedural safeguards in place to prevent illegal horizontal activity must continue to be observed, even among franchisees.

Fourth, franchisees and franchisors engaged in dual distribution retail networks should be forewarned, as the Court did not consider the impact the new rule will have on dual distribution arrangements where, for example, the franchisor sets prices to which both franchisor-owned stores and franchisees must adhere.

Fifth, because the legality of the vertical restraint will depend on market conditions, franchisors and distributors should exercise care in markets in which all competing brands adopt minimum resale price maintenance, even in the absence of collusion. The use of price restraints in combination with non-price restraints, like exclusive territories without quotas or other devices to promote aggressive interbrand competition, will factor into the rule of reason analysis.

Finally, state statutes expressly prohibiting minimum retail price maintenance have not been preempted, so national retail networks may not be able to adopt the same pricing arrangements in all states. This may impair the utility of vertical price restraints for some franchisors.

The long-term impact of *Leegin* is likely to be the spinning off of vertically integrated brand retail networks. It is also likely to encourage market entry by giving brand companies in start-up mode or with modest market niches the ability to compel price levels for their branded products that support substantial local service and retail outlet investments common to franchising. The ruling also gives some comfort to smaller merchants and start-ups who may be able to use vertical price restraints as protection against better capitalized and lower-cost retailers who discount to compete on price and avoid service.